Directions in Tax and Transfer Theory

Alan J. Auerbach
University of California, Berkeley

June 18, 2009

Overview

- Start with “accepted view” in public finance circa late-1960s
- Consider accumulation of theory and evidence since then, and the implications of these changes for the design of tax and transfer policy

The Traditional Setting

The Broad-Based Income Tax

The Broad-Based Income Tax

- Broad base permits low marginal tax rates and limits distortions associated with differences in tax rates on sources and uses of income
  - Limits reliance on tax expenditures
- High marginal tax rates not desirable, but acceptable at the top to achieve progressive tax burden

The Broad-Based Income Tax

- Progressivity achieved at low end largely through the transfer system
  - Arguments in favor of a negative income tax to reduce distortions of overlapping programs and in-kind redistribution
- Unit of taxation (individual vs. family) not uniform across countries
  - Income pooling advantages
  - Comparative distortions and family decision making process yet to be explored

The Traditional Setting

The Corporate Income Tax

The Corporate Income Tax

- Harberger model influential
  - Distortion of corporate-noncorporate capital allocation
  - Incidence on all capital
- Modigliani-Miller
  - Interest deductibility distorts debt-equity choice
- Can deal with both distortions through dividend relief (split-rate/imputation)

The Traditional Setting

Capital Gains and the Realization Principle

Capital Gains and the Realization Principle

- Not consistent with Haig-Simons income taxation (cash flows plus accretions to wealth)
- Understood to cause a “lock-in” effect
- But accepted as a practical way of dealing with unknown values of accruals and limited liquidity
- Provided an additional argument in support of corporate dividend relief

The Traditional Setting

Taxation of

Cross-Border Income

Taxation of Cross-Border Income

- Setting: Bretton Woods and capital controls
- But still had cross-border investment and need for norms
- Capital export neutrality (national neutrality): a natural way to think about efficient allocation of a country's capital
- Capital import neutrality: makes sense under some circumstances

The Traditional Setting

Theory of Second Best

Theory of Second Best

- A foundation for optimal tax theory
- An argument against piecemeal tax reform

Changes in Thinking, Evidence and Policy

Choice of Tax Base:

Income or Consumption?

Choice of Tax Base: Income or Consumption?

- Theoretical developments
  - Atkinson-Stiglitz
  - Chamley-Judd
- Practical developments
  - Meade Committee
  - US Treasury *Blueprints*
- Design advances
  - Flat tax and X tax

Choice of Tax Base: Income or Consumption?

- But also recognition of limits to gains from adopting consumption tax
  - Transition relief and progressivity limit gains
  - How big is the tax on saving that the consumption tax eliminates?
  - New dynamic public finance and the potential gains from taxing capital income

Changes in Thinking, Evidence and Policy

The Progressive Rate Structure

The Progressive Rate Structure

- Mirrlees: even with strong preferences for redistribution, we will generally not want steeply increasing marginal tax rates at top of distribution
- If individuals at the bottom don't work, then a negative income tax looks good

The Progressive Rate Structure

- But arguments for low top rates weaken as upper tail of the distribution becomes thicker and longer
- Several arguments against negative income tax
  - Gains from tagging
  - Gains from in-kind transfers
  - Gains from moving from unconditional transfers to EITC-type approach

The Progressive Rate Structure

- Also, labor supply elasticity (low) may not be the right one to look at in choosing marginal tax rates
  - Taxable income elasticity seems higher

Changes in Thinking, Evidence and Policy

The Family Unit

The Family Unit

- Marginal tax rates on second earners can be very inefficient under joint taxation
  - May even want *lower* marginal tax rates on second earner as first earner's income rises
- Within-family distribution of tax payments and transfers appears to matter
  - Resources not allocated via simple family-wide optimization

Changes in Thinking, Evidence and Policy

Stepping Back from Second-Best Theory

Stepping Back from Second-Best Theory

- Not all distortions are equal
- Production distortions are to be avoided, because they add a gratuitous reduction in productivity to what other distortions can achieve (Diamond-Mirrlees)
- Under relatively weak assumptions, direct taxes are superior to indirect taxes for optimal tax systems (Atkinson-Stiglitz)

Changes in Thinking, Evidence and Policy

Rethinking the Realization Principle

Rethinking the Realization Principle

- Distortions of realization-based taxation go well beyond the lock-in effect
  - Tax arbitrage
  - The additional distortions needed to support a realization-based system (e.g., loss limits)
- We are in a better position to move toward accrual or accrual-type taxation
  - More information and liquidity in markets
  - Ideas on accrual-equivalent taxes

Changes in Thinking, Evidence and Policy

Corporate Sector Distortions

Corporate Sector Distortions

- Distortions may not be as large as previously thought
  - Borrowing can reduce investment wedge (Stiglitz)
  - Progressive rates can make equity tax-favored (Miller)
  - Dividend capitalization can reduce extra burden on dividends (new view)
- So, gains from dividend relief not as clear

Corporate Sector Distortions

- As to incidence, some parts of corporate tax may not be shifted at all, but those that are may not land on all capital, but on less mobile factors

Changes in Thinking, Evidence and Policy

Taxing Foreign-Source Income

Taxing Foreign-Source Income

- Two important factors for company taxation:
  - Companies can change residence
  - Companies can raise funds from other countries
- Implication: old norms may apply more to taxation of individuals than to taxation of companies

Taxing Foreign-Source Income

- What is the right approach?
  - New norms?
  - Consider all relevant distortions for each type of tax system
  - Go beyond traditional approaches of residence-based and source-based taxation?

Conclusions

- Much new information and, in some cases, evident policy responses
  - Second-best theory not as paralyzing
  - Flatter marginal tax rate schedules
- But, in many cases, a more complicated perspective

Conclusions

- How much should we rely on the consumption tax?
- How do families allocate resources?
- Who bears the corporate tax?
- How should we tax foreign-source income?
- How close can we come to realization-based taxation?